Office of Chief Counsel
Internal Revenue Service

memorandum

CC:SER:KYT:NAS:TL-N-7325-98
HPLevine

VIA TELEFAX
(423) 545-4465

date: APR 8 1999

to: Chief, Examination Division, Kentucky-Tennessee District
Attention: Donald O. Spain

from: District Counsel, Kentucky-Tennessee District, Nashville

subject: [redacted]

Reference is made to our memorandum dated February 9, 1999, wherein we concluded in part that inclusion of an information schedule on the income tax return pursuant to Treas. Reg. § 1.451-5 was a requirement to qualify for the deferral of advance payments. The National Office has now changed its position and determined that the information schedule is not a requirement. All that is required for the taxpayer to change its method of accounting to this method without the Commissioner's consent based on a change in facts is that the taxpayer adopt this method in the first year when it could no longer use the long-term contract method. They suggested however that an alternative indication that the deferral method was elected must be evident from the books and records or income tax returns. The example provided is that the existence of deferred income or liability accounts for deposits would provide an indication of deferral of advance payments. The end result is that the National Office will not support disallowance based on the literal requirements of the Treasury Regulation if the taxpayer in fact was otherwise contemporaneously deferring advance payments and the argument is not being made in a belated attempt to recast the transaction.

The Treas. Reg. § 1.451-5 deferral provisions effectively allow a taxpayer to mismatch income and expenses. As an alternative, you may want to consider whether the I.R.C. § 263A UNICAP rules apply, which may require more of the production costs to be capitalized into inventory, which may reduce or eliminate the extent of the mismatching.

Please contact the undersigned at (615) 250-5072 if you have any questions. Since no further action can be taken by this office at this time, we are closing our file subject to reopening if additional assistance is requested.

JAMES E. KEETON, JR.
District Counsel

By: _____
HOWARD P. LEVINE
Senior Attorney

cc: Don Williamson ARC (LC)
(Via e-mail)

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DISCLOSURE STATEMENT

This advice constitutes return information subject to I.R.C. § 6103. This advice contains confidential information subject to attorney-client and deliberative process privileges and if prepared in contemplation of litigation, subject to the attorney work product privilege. Accordingly, the Examination or Appeals recipient of this document may provide it only to those persons whose official tax administration duties with respect to this case require such disclosure. In no event may this document be provided to Examination, Appeals, or other persons beyond those specifically indicated in this statement. This advice may not be disclosed to taxpayers or their representatives.

This advice is not binding on Examination or Appeals and is not a final case determination. Such advice is advisory and does not resolve Service position on an issue or provide the basis for closing a case. The determination of the Service in the case is to be made through the exercise of the independent judgment of the office with jurisdiction over the case.

ISSUES

1. Whether the taxpayer can defer as income advance payments that it receives on the manufacturing of [redacted] until the time that the product is shipped?

2. Whether the taxpayer is required to use the long-term contract provisions of I.R.C. § 460 in reporting its income?

CONCLUSIONS

1. The taxpayer cannot defer as income advance payments that it receives on the manufacturing of [redacted] until the time that the product is shipped under Treas. Reg. § 1.451-5 because it does not qualify for that relief.

2. The taxpayer is not required to use the long-term contract provisions of I.R.C. § 460 in reporting its income.

FACTS AND DISCUSSION

The taxpayer manufactures [redacted] equipment ([redacted]), which it sells to exclusive dealers. The list prices for the equipment range between $[redacted] and $[redacted]; the wholesale sales price is [redacted]% of the list price. The taxpayer receives [redacted]% of the purchase price as an advance payment at the time of order. The taxpayer claims that it initially reported income under the long-term contract method under I.R.C. § 460. However, due to manufacturing innovations that reduced the time to construct the [redacted] equipment to the current 6 to 9 months, they changed their method of reporting income. They currently report income when the [redacted] are shipped. They did not request a method of accounting change.

Income must be reported in the taxable year in which the taxpayer receives it unless, under the taxpayer's method of accounting, the item is properly accounted for in a different period. I.R.C. § 451(a); Straight v. Commissioner, T.C. Memo. 1997-569. Accrual method taxpayers must generally recognize income when all events have occurred which fix the right to receive the income and the amount can be determined with reasonable accuracy. Schulde v. Commissioner, 372 U.S. 128, 137 (1963); Straight v. Commissioner, supra; Treas. Reg. §§ 1.446-1(c)(1)(ii); 1.451-1(a).

Accrual basis taxpayers must generally include in income in the year received advance payments for the sale of goods that are unrestricted as to their use, even though those payments may not be earned until later years. Straight v. Commissioner, supra; Hagen Adver. Displays, Inc. v. Commissioner, 47 T.C. 139, 146-47 (1966), affd. 407 F.2d 1105, 1107 (6th Cir. 1969). Advance payments that the recipient can retain upon performance of the contract terms because of the legal relationship are taxable at the time that the payments are made. Commissioner v. Indianapolis Power & Light Co., 493 U.S. 203, 211-12 (1990); Highland Farms, Inc. v. Commissioner, 106 T.C. 237 (1996).

The Internal Revenue Service in 1971, issued Treas. Reg. § 1.451-5, which provided relief from Hagen Adver. Displays, Inc. v. Commissioner, supra, to allow for the deferral of advance payments received by accrual basis taxpayers from the sale of property which they build, construct, install or manufacture. Straight v. Commissioner, supra. Under Treas. Reg. § 1.451-5, an accrual basis taxpayer who receives an advance payment can defer recognition of that income until reported for financial accounting purposes. Treas. Reg. § 1.451-5(b). In the case of inventoriable goods, the advance payment must be reported by the end of the second taxable year following the year in which substantial advance payments are made. Treas. Reg. § 1.451-5(c).[1]

In this case, the taxpayer receives advance payments in year 1 and because of the 6 to 9 month manufacturing process, ships some of the equipment in year 2. It reports for both financial and tax purposes, income upon shipment of the equipment. This presumably occurs no later than year 2 because of the short manufacturing time. The taxpayer accounted for the advance payments at the time of shipping both for tax and financial accounting purposes only if it qualifies to do so under Treas. Reg. § § 1.451-5(b) and (c). While it appears that the taxpayer would otherwise qualify for deferral under Treas. Reg. § 1.451-5(b), we do not believe that the taxpayer can use this as its method of accounting because it has not received consent to do so and it has not otherwise complied with the information schedule requirements. Treas. Reg. §§ 1.451-5(d), (e).

The taxpayer previously accounted for its income under the long-term contract method under I.R.C. § 460. It later changed its method of reporting income in the 1990s as the manufacturing efficiencies shortened the manufacturing time to less than twelve months.[2]

The taxpayer is not required to report its income under the long-term contract method under I.R.C. § 460. A long-term contract is a manufacturing contract which is not completed within the taxable year in which it is entered into. Treas. Reg. § 1.451-

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[1] The taxpayer must however report the advance payment in income if its liability under the agreement otherwise ends. Treas. Reg. § 1.451-5(f).

[2] We presume that you determined and/or satisfied with the veracity of the change in facts claimed by the taxpayer, that is, that the manufacturing process previously was more than 12 months and has now been reduced to less than 12 months.

3(b)(1)(i). However, a manufacturing contract is a long-term contract only if the contract involves the manufacture of: (1) unique items of a type not normally carried in the finished goods inventory; or (2) items which normally require more than 12 calendar months to complete. Treas. Reg. § 1.451-3(b)(1)(ii). The taxpayer manufactures [redacted] separate [redacted] which are not specifically designed for the customer's needs. Moreover, the [redacted] are completed within 12 calendar months. Therefore, the taxpayer is neither required nor permitted to report its income under the long-term contract method under I.R.C. § 460.

The taxpayer changed its method of reporting income without the Commissioner's permission, which raises issues as to whether the change was permissible and whether an I.R.C. § 481 adjustment is required. A change of a method of accounting includes a change in the overall plan of accounting for gross income or deductions or a change in the treatment of any material item used in the overall plan. Treas. Reg. § 1.446-1(e)(2)(ii)(a). A change in the method of accounting does not include a change in treatment resulting from a change in underlying facts. Pacific Enterprises and Subs. v. Commissioner, 101 T.C. 1 (1993); Treas. Reg. § 1.446-1(e)(2)(ii)(b).

There appears to have been a change in the underlying facts when the manufacturing process time was reduced to under 12 months. Therefore, while it ostensibly appears that the change in the method of accounting did not require the Commissioner's consent, the taxpayer did not properly adopt the method of deferring the advance payments since no information schedule was attached to the income tax return. This argument was raised in the alternative in Straight v. Commissioner, supra, but not decided since the court decided the issue in favor of the Government on the basis that the taxpayer did not otherwise qualify under Treas. Reg. § 1.451-5. But see Peninsula Steel Products & Equipment v. Commissioner, 78 T.C. 1029 (1982) (where there is a choice of alternative methods and the method is substantially in accord with the regulations, great weight is given to consistency). See also Galan v. Commissioner, supra, where the court implied that the failure to include a net operating loss computational statement, required not by statute but by the Treasury Regulations, was not disqualifying, but evidence of the failure to establish the amount of the net operating loss for the intervening years between the net operating loss year and the year to which the loss was carried. However, the statement in this case may be determined to be a qualification requirement since income deferral under Treas. Reg. § 1.451-5 is permitted by regulation and not the Internal Revenue Code.

Since the taxpayer did not properly qualify for deferral of the advance payments under Treas. Reg. § 1.451-5, it is appropriate for the Commissioner to change the taxpayer's method of accounting if it does not clearly reflect income. Therefore, an income adjustment is appropriate to include in income the advance payments received by the taxpayer in the years under examination in order to clearly reflect income. I.R.C. § 446(b); Peninsula Steel Products & Equipment v. Commissioner, supra. Moreover, an I.R.C. § 481 adjustment is necessary, and the amounts deferred by the taxpayer in prior years, but not included in income, should be included in the first taxable year.

Please contact the undersigned at (615) 736-2072 if you have any questions. Since no further action can be taken by this office at this time, we are closing our file subject to reopening if additional assistance is requested. We have included the portion of the Government's brief filed in Straight v. Commissioner, supra that pertains to the Treas. Reg. § 1-451-5 statement requirement in order to assist you in the issue write-up in the event that you raise this issue.

Attached is a client survey which we request that you consider. The client survey is an initiative of the Southeast Region, and is an attempt to measure your satisfaction with the service provided by this office. We expect to be able to use your response to improve the services that we provide to you.

JAMES E. KEETON, JR.
District Counsel

By: _____
HOWARD P. LEVINE
Senior Attorney

Attachment:
Excerpts from Straight brief
Client survey